# LOS ANGELES BAR BULLETIN

*In This Issue*



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LOS ANGELES

# BAR BULLETIN

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## A WORD FROM THE PRESIDENT.

AS the vacation periods ends and the convention season begins, our thoughts turn naturally to the approaching conventions of the State Bar of California and of the American Bar Association.

At the State Bar Convention to be held at Santa Cruz from September 9 to 13, our Association will be represented at the Conference of State Bar Delegates by thirty-two of our members. Stevens Fargo will again act as Chairman of our delegation, with Earl C. Adams as Vice-Chairman and William P. Gray as Secretary. The program to be sponsored by our delegation includes legislation on such diverse subjects as blood tests in paternity cases, the order of instructions and argument in jury trials, and permission to defendants to interplead as to funds in their possession.

Many other members of our Association will participate actively in the State Conference and Convention. These include Julius V. Patrosso and Herbert Freston, President and Vice-President, respectively, of the State Bar; Melvin D. Wilson on the subject, "The Advantages or Disadvantages of Incorporation or Partnerships With Respect to Taxes"; Graham L. Sterling on "The Federal Securities Act"; Walter L. Nossaman on "Disposition of Property by Gift and Trust"; Homer D. Crotty

as moderator of panel discussion on "The Future of Legal Education in California"; and Judge Paul Vallee on "Trial and Preparation."

The annual meeting of the American Bar Association will be held at Cleveland from September 22 to 26. Our Association, which follows the policy of naming one of its Vice-Presidents as its representative in the House of Delegates, has this year appointed our Junior Vice-President, Charles E. Millikan. Two other members of our Association are ex officio members of the House of Delegates—Gurney E. Newlin as a former President of the American Bar Association and Loyd Wright as the member of its Board of Governors from the Ninth Circuit. Other Californians who are members of the House of Delegates are Charles A. Beardsley, former President of the American Bar Association; Delger Trowbridge, State Delegate; O. D. Hamlin, Jr., and M. B. Wellington, representatives of the State Bar of California; and Martin J. Dinkelspiel, representing the Bar Association of San Francisco.

Thus the Los Angeles Bar Association and its members play an active part in the work of the State Bar of California and of the American Bar Association.

Paul Fussell

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## THE PARTNER'S PROBLEMS AUGMENTED: HIS WIFE WRITES A WILL

**By J. Stanley Mullin, of the Los Angeles Bar**

WARTIME high income taxes on corporations greatly stimulated the use of the partnership form of doing business, and, although many clients are again returning to corporations, there are today many important businesses which are being conducted as partnerships. By "important," I am referring to those business interests which will constitute the sole or principal asset in the businessman's estate.

To bring the question into sharper focus, assume that we are dealing with a partnership interest representing an investment by Mr. Partner of $200,000.00, all of which is post 1923 community property, and that he has no other assets of consequence. Mr. Partner probably has made the switch to a simple general partnership because of the tax situation, and sees no reason why he should now shift back to a corporation. He is satisfied with

the financial integrity of his partners, he is no longer perturbed by the threat of individual liability and to him there appears no reason to incur the additional expense of shifting back to a corporate form of doing business. Chances are that he may have given some consideration to the problem of his widow's position after his own death, but it is probably unlikely that he has given consideration to the problems that will arise in the event that his wife predeceases him possessing, by reason of our Community Property Law, the right to dispose of one-half of the community property by her will (Probate Code 201).

## THE NATURE OF PARTNERSHIP PROPERTY

Assets held in a partnership are assets of the partnership and not assets of the individuals comprising the partnership. Partnership assets are not community property of the partner and his wife. A partner has (a) the right of management and control of the partnership property, which is his to exercise as an individual, (b) the right to share in the partnership income, and (c) the right to claim his proportionate share in the partnership net worth upon dissolution. A partner, unless restricted by partnership covenant, may sell and transfer to a stranger to the partnership a portion or all of his interests in the income and net worth (b and c above), but not his right of management and control (a above) (C. C. 2421). Such an assignee does not become a partner but merely holds a right (chose-in-action, C. C. 954) to share in the partnership distributions of income and net worth. This right has sometimes been referred to by the courts as a "potential" right, and it is this "assignable" interest in the partnership income and net worth which is subject to the community property claims of the wife. Thus, the wife's community property is the "potential" right to share one-half of whatever the husband receives by way of partnership income and net worth. She is a complete stranger to the partnership and does not have any right of management or control but she does have the power to make a will disposing of her chose-in-action and she may leave this interest to any person or group of persons. There is no reason to suppose she will leave it to her husband, because she has probably been urged by a well

meaning adviser to bypass the husband and avoid the death taxes upon his death.[1]

## NATURE OF PARTNER'S INTEREST IN THE PARTNERSHIP UPON HIS DEATH

Before examining the effect of the wife's will, let us briefly review the status of a partnership interest upon the death of a partner. During his lifetime, the interest of a partner in the partnership is the right to control the management of the partnership, as well as the right to share in the income and net worth. Upon the death of a partner, the partnership dissolves, is wound up and liquidated, either according to the terms of an existing contract for that purpose or according to normal liquidation procedures. The surviving partners, by law, are possessed with the right to manage and control the liquidation of the partnership business. The deceased partner's executor must inventory as an asset the deceased partner's "potential" right to share in the net worth of the partnership when the same is distributed pursuant to the dissolution and winding up. The executor, although he may appear to hold the decedent's interest, does not have any rights to act as a partner in the managament or control of the business; he possesses solely the right to demand an adequate and full accounting and liquidation.[2]

Assuming that the partnership articles do not provide for the continuation of the partnership for a fixed term, or for the formation of a corporation, or for the purchase of the decedent's

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[1]See:
Civil Code, Sec. 2412, *et seq.;*
20 Cal. Jur., p. 788, *et seq.;*
*Theller v. Such,* 57 Cal. 447 (1881);
*Andrade v. Superior Court,* 75 Cal. 459 (1888);
*Raisch v. Warren,* 18 Cal. App. 655 (1912);
*Currie v. Landes,* 55 Cal. App. 73 (1921);
Sinclair: Administering Partnership Interests, p. 11.

[2] Civil Code, Secs. 953, 954, 2423, *et seq.;*
Probate Code, Secs. 571, 572, 573, 581, 600, 601, 774;
de Funiak: Principles of Community Property (1943), p. 220;
11B Cal. Jur., p. 272, *et seq.;*
8 McKinney, Decedent's Estates, Secs. 191, 192;
18 McKinney, Partnerships, Sec. 92;
Bancroft: Probate Practice, Secs. 506, 507, 1241;
*Vasiljevich v. Radanovich,* 138 Cal. App. 97 (1934);
*Estate of Grivel,* 10 Cal. (2d) 454 (1937).

interest by the surviving partners,[3] the executor will eventually come into possession of Mr. Partner's share of the liquidated partnership in the form of assets which are free of any partnership restrictions and which he may, in turn, distribute to the beneficiaries entitled to Mr. Partner's estate. Upon the death of Mr. Partner, his executor is clothed with certain specific rights and privileges specified by the Code provisions, all of which serve to guarantee that he receives Mr. Partner's proportionate share of the liquidated partnership assets.[4] It is to be specifically noted that these provisions do not apply to the executor of the will of a partner's wife.

## NATURE OF WIFE'S INTEREST IN THE PARTNERSHIP UPON HER DEATH

When the wife dies before Mr. Partner, there is nothing to prevent the partnership from continuing as usual. As pointed out above, she did not have a direct interest in the partnership assets, nor did she have a direct managerial interest as a partner. Simply stated, her estate has a potential right to one-half the husband's right to share in the net income and net worth of the partnership—when, as and if, in his hands.[5]

The wife's executor proceeds to inventory this asset something like this—"Decedent's community interest in one-half of husband's interest in DeLuxe Manufacturing Co., a copartnership consisting of three persons, etc." From that point forward, the

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[3]These problems have been the subject of numerous articles, some of which are:
8 Fletcher on Corporations 4007;
50 Yale Law Review 202;
19 So. Calif. Law Review 1;
33 Harvard Law Review 1070;
55 Harvard Law Review 909;
60 Harvard Law Review 123;
80 A. L. R. 12, 1034;
160 A. L. R. 523;
White: New Approach to Partnership Insurance (Prentice Hall Special Report);
Insurance Counsel Journal, January 1947, p. 26.

[4]See:
Civil Code, Sec. 2436;
Probate Code, Secs. 571, 774;
18 McKinney's Digest: Partnership, Sec. 92.

[5]Bancroft: Probate Practice, Secs. 12, 506, 507, 1144;
Sinclair: Administering Partnership Interests, p. 23.

executor is faced with a far different situation than the executor of a deceased partner. He has an asset which is merely a chose-in-action. The executor cannot compel the liquidation of the partnership, as the partner is surviving; he has no right to interfere with the managament of the partnership, nor to substitute himself or the beneficiary as a full-fledged partner. The executor has in his possession for distribution rights to share in the income and net worth of the partnership, rights which may best be compared to the rights of a direct assignee of the partner. The executor may be forced to sell this asset in order to place the estate in funds with which to meet expenses, taxes and specific legacies.[6]

If the executor is tending to his business, he will look closely to the values placed upon the probate estate by the Inheritance Tax Department and the Federal authorities because, most likely, such appraisals of this chose-in-action will be exactly one-half of the husband's apparent proportion of the partnership net worth (*i.e.,* one-half of $200,000.00, or $100,000.00), using as a basis for such determination the partnership profit and loss statement and balance sheet computed as of the date of the wife's death (Probate Code, Sec. 600). It well may be the case that this appraisal is not warranted:

(1) The estate's interest is dependent upon the partner's rights upon liquidation or dissolution of the partnership which, in turn, may be circumscribed by covenants in the Partnership Articles providing for purchase of his interest by surviving partners, by a covenant to form a corporation upon dissolution, by a covenant providing for liquidation according to a fixed formula, etc.

(2) The estate's interest is not an interest in one-half of the partnership assets until such time as the partnership is wound up at a future date; in the meantime, it is only a right to receive income. Therefore, it is an asset which should be valued by (a) capitalizing the income to be received prior to dissolution, (b) discounting to today's value the receipt of capital upon future dissolution of the partnership.

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[6] Probate Code, Sec. 774;
*Currie v. Landes,* 55 Cal. App. 73 (1921).

(3) If the estate has no cash with which to pay death taxes, a "forced sale" of the chose-in-action may definitely set the value below that of the partnership books.[7]

This approach to the valuation problem may well produce a very different result than that produced by taking a precise fraction of the partnership's net worth.

**THE RELATIONSHIP OF THE WIFE'S BENEFICARY TO THE PARTNERSHIP**

The wife's executor can only turn over to the wife's legatee (or purchaser at a probate sale) exactly what he has received, and such beneficiary is in the same position as a direct partial assignee of Mr. Partner. About the time that Mr. Partner first pays over to such beneficiary one-half of all his current income from his hard work as a partner, he becomes aware of the fact that things are not the way he would like to have them. His reaction will be particularly violent if the beneficiary (or the purchaser at a probate sale) is not the object of his affection and this beneficiary follows the normal inclination to question his activities and accounting as a partner. What can Mr. Partner do to relieve himself of the constant irritation arising from this unexpected relationship of assignor and assignee?

(1) Mr. Partner can try to buy the beneficiary's interest, but the beneficiary may have exaggerated ideas of value and hold Mr. Partner up for a price which is, in his opinion, inequitable. Furthermore, Mr. Partner does not possess the necessary cash to buy out the beneficiary, all of his capital having been invested in the partnership.

(2) To get ride of the assignment, Mr. Partner will probably be forced to engineer a dissolution and liquidation of his partnership, pay off the beneficiary, and reform the partnership and start over again. Having done this, he is now a partner with a one-sixth interest rather than a one-third interest, and he will undoubtedly be disgruntled with both the law and lawyers for having gotten him into such a fix.

Psychologically, it seems much harder for clients to part with a portion of their partnership interests to a stranger than to part

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[7] *Katz v. Nee,* 68 Fed. Supp. 490 (1946).

with shares of stock of a corporation. This is so undoubtedly because of the absence in the partnership relation of the separate corporate entity which permits a person to have managerial control without proportionate ownership of the outstanding shares.

**STEPS TO BE TAKEN TO AVOID COMPLICATIONS ARISING UPON THE WIFE PREDECEASING THE PARTNER**

Being aware of the problem is sufficient to set into motion several alternative methods of solving the problem arising from the wife predeceasing the husband-partner. They are approximately the same solutions applied to the problems arising upon the death of the partner, which problems have been rather well covered by court decisions and legal articles (see footnote (3) *ante*).

(1) The husband might make certain that the wife's will disposes of the community property interest in a manner which will be agreeable to the husband if he is the survivor. This is not entirely satisfactory, as the wife may decide to change her beneficiaries from time to time and it is unlikely that the family wills are kept abreast of the husband's changes in his business setup.

(2) The husband and wife, by agreement, may provide that her estate shall sell the community one-half interest to the husband at a fair price fixed by a definite formula (a fair fixed price is preferred over an option in order to assure a definite valuation of the asset for inheritance and estate tax purposes).[8]

To provide the funds with which to buy out the wife's community interest without withdrawing the funds from the partnership necessarily entails either a sound savings investment program by the husband outside of the partnership or some type of insurance which will provide the requisite funds. Neither of these is wholly satisfactory because it is impossible to predict the precise amount required to make the purchase at an uncertain future date and the average client usually has the greatest reluctance to withdraw assets from a profitable business.

(3) All of the partners and their wives may provide by

[8] *Wilson v. Bowers*, 57 F. (2d) 682 (1932);
*Cf. Armstrong v. Commissioner*, 146 F. (2d) 457 (1944), and *Spitzer v. Commissioner*, 153 F. (2d) 967 (1946).

agreement that, upon the death of the wife of a partner, the partnership shall be transformed into a corporation so that all the surviving parties and the wife's executor hold shares of stock in proportion to their interests. These shares of stock in the possession of the executor are then free for distribution in accordance with the provisions in the wife's will. This type of contract permits the retention in the business of all the invested capital, the estate may sell the shares with no important effect upon the partners, the wife's beneficiary becomes a minority stockholder, testamentary trusts are possible, and the added expense of doing business as a corporation is offset by the freedom of the partners from the complications and harassments which have been noted above.[9]

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# ESSENTIAL FACTORS OF A MODERN CALIFORNIA WILL*

**By Elmo H. Conley, of the Los Angeles Bar**

A FEW DAYS after I was assigned the topic for this address, I happened to meet a former president of the California Bankers Association. I asked him what he thought I should talk about.

"Well," he said, "your audience will be composed of *bankers* and *trust officers.* Most of them will be *lawyers.* Therefore I would advise you to confine yourself to two points: First, come out strongly in favor of banks and trust companies as executors and trustees; and Second, insist that the testator always consult his lawyer about his will. This program will please everyone, insult no one, and the rest of your speech won't matter very much."

Strictly speaking, there are not many *essential* factors in a will. For example, here is the simplest form of a will:

"May 27, 1947. I leave everything to Mary.

(Signed) John."

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[9]The tax aspects of the particular solution adopted should be examined carefully as this article does not purport to cover the tax rulings.

*An address delivered May 27, 1947, before the Fifty-sixth Anniversary Convention of the California Bankers Association at Hotel Del Coronado.

If this is wholly written, dated, and signed in John's handwriting, it is a perfectly good holographic will in California—at least so far as the *essential factors* are concerned. (Probate Code, Sec. 53.) On the other hand, from the standpoint of John's family, it might be and probably is the worst will he could have made.

Even were we to overlook such questions as forgotten children, the lack of an executor, the absence of any powers of sale, etc., we usually find that John has saved a meager attorney's fee at the expense of a good many thousands of dollars in Estate and Inheritance taxes, which could have been avoided if his will had been properly drawn.

In most branches of the law, the modern tendency is toward simplicity. Unfortunately, the reverse is true in regard to wills. From time to time, a client will say: "I do not like the will you have drawn for me because it is too long and complicated, so I have drawn a simple one myself in my own handwriting saying just what I mean!"

Then I ask him: "Why is it that an experienced business man who has spent a lifetime accumulating his fortune will insist on attempting to dispose of it in words of one syllable on a single page?"

He repeats: "I want it short and simple."

I do my best to explain to him that the reason a will drawn by a lawyer is lengthy is because there are many, many points to be covered which would never occur to him.

Sometimes he is convinced, sometimes, not. If he persists in leaving his "home made" will—at least the lawyer can look forward to plenty of work (for which he will be well paid) when the will is probated.

## Complexities in Modern Wills

A modern will is complex, not because the lawyer wishes it so, but rather because of the fact that nothing can be omitted or left to the imagination. The instrument must be complete within itself. The executor and the trustee have only such powers as the will provides and no more—except for a very few that are supplied by statute. The estate must be fully disposed of—or

it may pass to someone not intended by the testator. Trusts must extend just so long and no longer. If they are not terminated properly, they may violate the Rule against Perpetuities and be invalid from the outset. At all times, the tax implications of each paragraph must be considered—both as to death duties and future income taxes. The only lawyer who can dispose of all of these problems by merely copying paragraphs from a form book is one who does not understand the problems.

Assuming, then, that the modern will is not to be a simple will, but rather an *adequate* one, what are some of the problems to be faced?

If the estate is substantial in size, it may be assumed at the outset that the instrument will provide for a life estate of some sort with remainders over to a second generation. The reason for this, of course, is to prevent double taxation.

For example, if a husband dies leaving a net estate of $1,000,000 the Federal estate tax will be $303,500 leaving only

$696,500 for distribution. If the wife dies more than five years later, the Estate tax on the $696,500 will be $189,380. Almost the first question a lawyer should ask is whether or not the client would like to save this $189,380. Of course, the answer is usually "yes!"

This purpose may be accomplished in one of two ways—either by using the old common law life estate, or the more modern trust.

Strange as it may seem, modern draftsmen have revived the old-fashioned life estate in lieu of a trust under certain circumstances—although this probably should not be mentioned in the presence of bankers and trust officers!

## Use of Life Estates

Needless to say, the circumstances must be exactly right to indicate the use of a life estate. If it is to be used at all, the proposed life tenant must be experienced in business, and willing to undertake the active management of an estate. He must be absolutely honest and trustworthy. The testator must be certain that he will not permit the life estate to be wasted either voluntarily or through bad judgment.

If the life tenant meets all of these qualifications, the will may provide that the entire estate shall go to the life tenant for life with remainder over to designated persons, and that the life tenant shall have the power to sell or exchange any portion of the estate without the consent of the remaindermen, but subject to the duty to reinvest the proceeds. The purpose of this power of sale, obviously, is to allow the life tenant to change investments when it seems advisable without too much difficulty. Such powers are recognized at common law, and since the life tenant cannot invade the corpus, the remainder is subject to no estate or inheritance taxes upon his death.

As a rule, this device is used in a wife's will where her husband is a business man and desires to continue to manage *all* of the family property after her death. There is some saving of expense over a trust, of course, but this is usually comparatively unimportant because of the fact that trustee's fees are deductible for income tax purposes. This plan is seldom used in

the husband's will, for the wife usually needs the help and advice of a trustee.

In the absence of a model life tenant—then, of course, the conventional vehicle to avoid double taxation is the trust—with income for life to named beneficiaries, and subsequent distribution at the end of the trust to designated persons or classes.

## Testamentary Trusts

The trust, of course, is the *safest* and most *flexible* method for tax-saving purposes. It is safe if the trustee is efficient and trustworthy. We still hear stories of what happened to Mrs. X's trust in 1932, but most testators can be convinced with a little argument that corporate trustees, at least, can be trusted. As a last resort, some individual may be added as a co-trustee or a consultant, but in any event the trustee hurdle usually can be negotiated.

Now as to the matter of *flexibility*. A trust may be molded to fit almost any situation which may arise. The testator may divide the income into as many shares as he may see fit. This cannot be done very well with common law life estates, for the management problem would be almost insuperable where there are multiple life interests. Furthermore, he may make cash bequests payable at the termination of the trust or may give specific parcels of real estate to each of his children. The trust is the only vehicle which will permit such variations.

## Emergency Clauses to Protect Beneficiaries

Another example of flexibility is to be found in the use of the so-called "Emergency Clause." When the lawyer suggests the use of a trust to save double taxation, his client frequently raises this objection: "What if the income is insufficient to take care of my wife?" This problem may be handled very easily. It is now well established that the trustee may be given the power to invade the corpus for the benefit of the wife or children without serious tax complications—if the language of the clause is sufficiently limited.

These emergency clauses have been before the courts in many recent tax cases—particularly where the remainder over after the life estate goes to some tax-exempt charity. In these cases, the question involved is the value of the gift to charity.

In the earlier case of *Ithaca Trust Co. v. U. S.,* 279 U. S. 151 (1928), the court approved the language permitting invasion of the corpus as to any sums "that may be necessary to suitably maintain her in as much comfort as she now enjoys." The court found that this was a sufficiently definite standard to be capable of reduction to "definite terms of money."

It seems very well settled that the Emergency Clause may safely permit invasion of corpus for "care, maintenance, and support" (*Est. of Wetherill,* 4 T. C. 678 (1945)), or "comfort and support" (*Est. of Jack,* 6 T. C. 241 (1946)). However, where the word "happiness" was added, and the trustee was instructed to act "with liberality," the court held the language was too uncertain (*Merchants National Bank v. Com.,* 320 U. S. 256, 88 L. Ed. 35; 64 Sup. Ct. 108 (1943)). In another recent case (*Est. of de Castro,* 4 T. C. M. 636 (1945)), the court refused to sanction the words "supply *amply* the needs" of the beneficiary. In such cases, the entire estate is taxed without the benefit of any charitable deduction.

From a consideration of all of these cases, it would seem that if the will permits the trustee to invade the corpus for the "care, maintenance, and support of the beneficiary in the manner in which she has been accustomed," the maximum protection for the beneficiary consistent with tax safety will be accomplished.

### Discretionary Trusts

Another modern example of flexibility in trusts is found in the so-called "Discretionary Trusts." Here testator leaves his entire estate to a trustee in trust to pay *so much* of the income to his wife as the trustee may, in his sole discretion, see fit. A like provision is made for each child, if desirable. The undistributed portion of the income is added to the corpus.

This, of course, is flexibility to the *nth* degree. Where the estate's income is large, and where under the usual trust all of it is payable to the life tenant, a very large portion must be paid by the life tenant for income tax. On the other hand, under the Income Tax Act the life beneficiary pays income tax only on so much of the income as the trustee may distribute, while the trustee pays the tax on any undistributed income. If any distribution is made to the children, they will pay the income tax

on their share. The advantage of the Discretionary Trust is, of course, to keep income taxes in lower brackets by adding the unused portion of the income to the corpus.

Under the existing statutes and decisions, Discretionary Trusts will accomplish this income tax savings—so long as the beneficiary has nothing to say about the exercise of the discretion. If, on the other hand, the distribution of income is within the discretion of the *beneficiary,* then *all* of the income is taxable to such beneficiary whether or not it is actually distributed to him. This, of course, is a good argument for a corporate trustee.

The principal objections to the plan are three-fold: (1) it places a heavy responsibility on the trustee to be required to exercise such a discretion; (2) it is very difficult to calculate the State inheritance taxes; and (3) the Income Tax Law may change. Perhaps the answer to the last objection is that, after the change, although all of the income may be taxed to the wife, nevertheless she is no worse off than she would have been from the beginning under the usual trust and there have been several intervening years of tax-saving.

**Use of Powers of Appointment**

One of the older methods of insuring flexibility in a trust was the use of "powers of appointment." The testator would leave his estate in trust to pay the income to a named beneficiary for life with the usual provisions for distribution to designated remaindermen upon the termination of the trust—but subject to a power in the life beneficiary to appoint the estate upon his death to anyone whom he might designate (termed a "General Power") or to his spouse or descendants (termed a "Special Power"). Until the enactment of estate and inheritance tax laws, this was an excellent plan for deferring for one generation any final decision as to the ultimate vesting of title.

Then came the era of death duties, and the troubles of the will draftsmen began. At the outset, the estate and inheritance tax laws did not attempt to tax such powers unless they were exercised—so the lawyer had to be very careful not to exercise a power unless absolutely necessary. Then came the 1942 Amendments to the Estate Tax Act which provided that all property subject to a *general* power is subject to tax in the donee's estate irrespective of whether he exercises the power. This, of course, means that general powers of appointment should not be used in new wills and usually should be surrendered in existing trusts. The Revenue Act of 1942, however, excepted *special* powers from its provisions, so that even today when a special power is exercised in favor of spouses, descendants, or charities, the property is not included in the donee's estate.

Should "special powers" be used in modern wills in view of the present state of the law? It would seem that the answer is "no." Congress may amend the Estate Tax Act again to render "special powers" taxable. It is conceivable that next time Congress will not exempt the surrender of such power from the provisions of the gift tax law as it has done in regard to the surrender of general powers. For this reason, it is much safer to avoid the use of powers of appointment if it is at all possible to do so.

But this raises a further question as to what is a "power of appointment." Very often the testator may create a taxable power of appointment under his will without intending to do so.

For example, Section 81.24 of Regulation 105 provides as follows:

> "The term 'power of appointment' includes all powers which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and local property law connotations. For example, if a settlor transfers property in trust for the life of his wife with the power in the wife to appropriate or consume the principal of the trust, then the wife has a power of appointment."

Suppose the will names decedent's wife as trustee and then contains an emergency clause giving the trustee the right to invade the corpus to provide the life beneficiary with reasonable support, care, and comfort. If the wife is also the trustee, then the entire trust corpus will be included in her estate upon her death merely because of the *existence* of the emergency clause, even though she may never have actually invaded the corpus. The same unfortunate tax consequences would result in the case

of a life estate to the wife with a power to invade the corpus, even though she might not take advantage of such power.

Here, again, if the will provides for an independent trustee to decide all questions as to invasion of corpus, there is no risk of double taxation.

### Should Beneficiary Have Right to Remove Trustee and Substitute Another?

Frequently a client insists that a clause be inserted in the will permitting the beneficiary to remove the trustee and to substitute another trustee. The avowed purpose of such a provision is to permit the beneficiary to hold a club over the trustee—to make the trustee behave and not charge too much, etc. Of course, such a clause is repugnant to the very idea of a trust, for the entire trust relationship is based upon the confidence which the trustor has in the trustee. If the trustor lacks faith in the particular trustee, he should either select another trustee or omit the trust altogether.

These arguments, of course, are old-fashioned, and the client frequently remains unconvinced. But now, to go one step forward—insert in the will a power to invade the corpus within the discretion of the trustee, and then give the beneficiary the power to remove the trustee and name a new one. Who, then, will be exercising the discretion—the beneficiary or the trustee. Certainly the beneficiary can find some trustee who will invade the corpus for him. Will such a combination of powers and discretions be construed as a "power of appointment" by a life tenant with a resulting tax at his death? There are no cases as yet upon this point. However, you can see one more *modern* reason why the beneficiary should not have the power to remove the trustee.

The only alternative to an independent trustee in cases where an invasion of corpus may be necessary is a definite non-cumulative annual ceiling on the amount which the life tenant may take from the corpus. In *Bankers Trust Company v. Higgins*, 136 Fed. (2d) 477 (1943), reaffirmed CCA-2, Jan. 7, 1947, it was held that the maximum amount includible in the life tenant's gross estate upon his death was the present worth on the date of the life tenant's death of the prospective invasions of principal during the balance of his life expectancy. Now, if this formula seems complicated and difficult to understand, as it does to me, then we can avoid such difficulties by using an independent trustee.

Perhaps you may have wondered at the outset why a *lawyer* such as the speaker is so favorable toward the corporate trustee. Lawyers have been known to assert that the trust companies were taking their business away from them, etc. Of course, this audience knows that this is not true! From the standpoint of the draftsman of a will, the use of an independent corporate trustee is a *certain way of avoiding* many technical tax questions. It is in cases where some interested member of the family is to be named as trustee that the lawyer must beware.

### Effect of Estate Laws on Community Property

One of the most puzzling problems with regard to wills is the proper treatment of community property. It must be recognized at the outset that both the husband and the wife have a right to dispose of one-half of the community property. Every will of

a married person should specify in exact language the intent of the testator in regard to his or her one-half. In the case of the wife, if she desires to dispose of her share of the common property, she should say in so many words: "It is my intent to dispose of my share of the community property which stands in my name or the name of my husband." If she intends to dispose only of her separate estate, she should so state. Likewise, the husband should state clearly whether he intends to convey only his one-half of the community property, or all of it. If the latter is intended, then he should clearly require the wife to elect between community rights and the provisions made for her in the will. He should also specify clearly what portion of his own one-half of the community property, if any, is to go to her if she elects to exercise her community rights. The Supreme Court Reports are full of cases where controversies have arisen between wives and children where the language of the will was ambiguous.*

So far, we have confined our discussion of community property to the problem of the use of clear and unambiguous language. Perhaps the other phase of the problem is even more important, namely, the Estate tax implications.

It is almost unnecessary to point out that the Community Property states not only lost all of their former Estate tax advantages, but have really been discriminated against since the 1942 Amendments to the Federal Estate Tax Act. Prior to 1942, the widow received tax-free her one-half of the community property acquired subsequent to July 29, 1927. This, of course, reduced the Estate tax to one-fourth or one-third of that collected where decedent died a resident of a non-community state. The 1942 Amendments, however, changed this by making *all* the community property taxable in the husband's estate if he died first and *one-half* of it taxable if the wife died first. By comparison, none of the property acquired by the husband and wife after marriage is taxed in non-community states where the wife dies first.

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*In cases in which one spouse leaves *all* of his or her estate to the other spouse either outright or for life, it is often unnecessary and sometimes unwise to distinguish between community and separate property.

Now let us consider for a moment what can be done about this unfortunate situation.

### Necessity for New Legislation

First, of course, we should attempt to secure new legislation. Last fall, at the American Bar Association Convention, the Tax Section discussed at length the Treasury Department proposal to extend to all of the states the right of the husband and wife to divide their income for income tax purposes as they now do in Community Property States. Members from California, Texas, etc., opposed this proposal, but it was quite apparent that it was about to receive the indorsement of the Section. A compromise was suggested whereby the delegates from Community Property States would approve the Treasury Department proposal in return for which the repeal of the 1942 Amendment taxing the wife's estate with one-half of the community property would be recommended unanimously. This compromise was adopted—so *perhaps* the 1942 Amendment may be repealed, perhaps not.

In any event, we now have this unfortunate legislation on our statute books, so how shall we handle the problem in drawing the husband's and wife's wills?

The answer is, we should take advantage of the situation to divide the community estate into two parts, thus keeping each half in the lower tax brackets.

### Advantages of Dividing Community Property

Don't overlook the fact that the wife has the right to dispose of her one-half of the community property. By all means, have her execute a will disposing specifically of her one-half share. If she dies first, a substantial tax saving will result.

Her will, however, must name the children rather than her husband as beneficiaries. If, for any reason, she wishes to leave him the *income,* she may do this either through a life estate or a trust for life. Remember, her estate will be taxed for her share of the community property whether or not she disposes of it. She must not be allowed to overlook such a tax-saving by dying intestate or with a so-called "simple" will.

Let us reduce this suggested tax saving to a set of figures. Assume an estate of $500,000, all community property:

CASE I.
(Incorrect Method)

| | |
|---|---|
| Wife dies first, intestate (all community property passing to her husband) | |
| (a) Federal estate tax upon $250,000 at her death | $ 47,700 |
| (b) Federal estate tax upon $452,300 (*i.e.,* $500,000 less $47,700) at husband's death | 111,236 |
| Total taxes | $158,936 |

CASE II.
(Correct Method)

| | |
|---|---|
| Wife dies testate, leaving her one-half of community property to children. | |
| (a) Federal Estate Tax upon her death | $ 47,700 |
| (b) Federal Estate Tax upon husband's death | 47,700 |
| Total taxes | $ 95,400 |
| Total saving if correct method is followed: | $ 63,536 |

A much larger percentage is saved in an estate of $200,000.

| | |
|---|---|
| Case I. Total taxes | $30,060 |
| Case II. Total taxes | 9,600 |
| Total saving | $26,460 |

Now let us look at the husband's will. He should dispose of *all* of the community property (with his wife's consent). Here, again, though, he must create a trust or a life estate, preferably the former, where the wife is the survivor. He should leave to his wife *in satisfaction of her community interest* a life income as to all or an adequate portion of the estate, with remainder over to the children. Thus, the $126,500 tax paid at his death would be all the Estate tax that would ever be paid in passing the community property after a life interest in his wife to the ultimate beneficiaries, the children.

**Importance of Providing for Source of Tax Payments**

One of the most important parts of a modern will is the tax clause wherein the testator specifies the source from which all death duties are to be paid. Here, again, the testator must say exactly what he means, or unfortunate results may happen. There is no subject in recent years which has caused more litigation than that as to the ultimate impact of Estate and Inheritance taxes.

The California Legislature in 1943 enacted a new Probate Code Sec. 970 providing for the prorating of the Federal Estate Tax. Any tax clause drafted prior to 1943 should be re-examined to ascertain whether it correctly states the testator's intentions *after* the new legislation has taken effect.

In order to establish a background for a proper understanding of Sec. 970, we must consider the state of the law before 1943.

First let us examine the Estate Tax law. From the time of its original enactment in 1916 it has been concerned primarily with the *assessment* and *collection* of an estate tax rather than its ultimate impact. So far as the estate tax law itself is concerned, the tax is payable out of the residuary estate. (*Y. M. C. A. v. Davis,* 264 U. S. 47; *Harrison v. Northern Trust Company,* 317 U. S. 476.) The single exception to this as far as the Federal statutes are concerned is found in Internal Revenue Code 826(c), which gives to the executor the right to collect a pro rata share of the total estate tax from the payee of life insurance policies. Except in the case of insurance, the residuary estate is liable for the entire estate tax unless the law of the State in which the estate is being administered expressly appor-

tions it among the beneficiaries. Furthermore, the executor is personally liable if he pays debts or if he distributes the estate without making provision for the payment of estate tax. (Revised Statutes, Sec. 3467; *U. S. v. Huntington National Bank,* 34 Fed. Supp. 578, Affirmed 117 Fed. (2d) 376.)

**Effect of Section 970, Probate Code**

For many years the residuary estate continued to bear the brunt of the entire estate tax, often to the detriment of widows and children who were the primary object of the testator's affections. Attempts were made to cure this situation by resort to courts of equity to establish some equitable theory of proration, but in most jurisdictions such attempts were failures in the absence of specific legislation. Finally, New York enacted Section 124, New York Decedent Estate Law, providing that the executor may, in the absence of a contrary direction of the testator, be entitled to reimbursement for a proportionate share of the tax from holders of property not passing to the executor but required to be included in the gross estate. This was followed by legislation in various other states and finally in 1943 California Legislature enacted Probate Code Section 970 which provides as follows:

> "970. (Proration of amount of tax paid.) Whenever it appears upon any accounting, or in any appropriate action or proceeding, that an executor, administrator, trustee or other fiduciary has paid an estate tax to the Federal Government under the provisions of any Federal estate tax law, now existing or hereafter enacted, upon or with respect to any property required to be included in the gross estate of a decedent under the provisions of any such law, the amount of the tax so paid, except in a case where a testator otherwise directs in his will, and except in a case where by written instrument executed *inter vivos* direction is given for apportionment within the fund of taxes assessed upon the specific fund dealt with in such *inter vivos* instrument, shall be equitably prorated among the persons interested in the estate to whom such property is or may be transferred or to whom any benefit accrues."

You will note from an examination of the foregoing section that the situation has now been completely reversed in California.

Prior to the enactment of this statute, California *did not permit* a proration of the Federal estate tax except in cases where the will or other written instrument so directed. (*Wells Fargo Bank v. Older,* 50 Cal. App. (2d) 724; 123 Pac. (2d) 873.) Since 1943 equitable proration is *required* "with respect to any property required to be included in the gross estate of decedent" except in a case where decedent otherwise directs.

It is because of this complete reversal of policy in California that tax clauses drafted prior to 1943 must be re-examined. Prior to 1943 most of the tax clauses found in the form books were concerned solely with state inheritance taxes.

### Suggestions for Tax Clauses

Let me reiterate—under Section 970 the Federal Estate Tax will be prorated unless decedent otherwise directs. It is advisable to give this direction by will rather than by an *inter vivos* instrument because of possible limitations upon the latter. No particular form for such direction is specified, but in general the following is suggested:

(1) If the testator intends to make estate and inheritance taxes upon his *testamentary estate only* a charge upon the residue, he should refer specifically to his "probate estate" or the "estate passing under this will" or to "devises and legacies given under this will," or some similar language.

(2) If he intends to charge the residue with *all* death taxes upon his entire taxable estate, he should direct the executor "to pay out of the residue all estate, inheritance, succession, or other death taxes or duties imposed by and made payable under the laws of the United States, or any State or Country *by reason of my death,*" and further direct that there shall be "no apportionment of such taxes." It is further suggested that there be no specific reference to *inter vivos* transfers or gifts for reasons which are obvious to any tax-conscious lawyer.

(3) It is only in cases where testator desires to have the Federal Estate Tax prorated and the various beneficiaries charged with the State Inheritance Tax that no tax clause is necessary.

**Conclusion**

In conclusion: May I remind you that I have "come out strongly in favor of banks and trust companies as trustees." I have also stated reasons why it is necessary for a testator to consult his lawyer. If you will carry away with you just two points—first that an independent trustee is a vital factor of safety; and second that the drawing of a will is a serious undertaking—then the rest of my address will not have mattered very much—as my banker friend predicted.

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